

## SMALL FARMERS DEVELOPMENT BANK DUE DILIGENCE REPORT

### A. Project Design Analysis

#### 1. Overview of Project Design

1. A 7.8 magnitude earthquake on 25<sup>th</sup> April 2015 and 7.3 magnitudes on 12<sup>th</sup> May 2015 hit Nepal. About 9,000 people have lost their life, about 20,000 people are severely injured and eight million people affected by the quake. Out of total 75 districts, 17 districts<sup>1</sup> were worst affected. The earthquake damaged the houses, crops, cattle and other property of people. UNESCO's recognized World Heritage sites in Kathmandu Valley were also destroyed. Government and private offices, banks' buildings and factories were also damaged. The damage is more severe in informal sector including agriculture and micro and small enterprises, sector and to poor and vulnerable people. Many farmers in the affected districts have lost their livelihood (crops and livestock) and houses. It is estimated that about 400,000 micro and small entrepreneurs have lost their enterprises. The National Planning Commission has estimated that about 700,000 people's livelihood has been severely affected and they are pushed back below the poverty line.

2. If appropriate interventions are not devised to revive the business and economic activities of the poor, life of the many poor families will be miserable after the quake. If the business of clients could not revive, they will not be able to pay back the outstanding loan of cooperatives/microfinance institutions (MFIs). Due to high delinquency of outstanding loan and severe liquidity crunch, many small MFIs and cooperatives will be in difficult position. This will adversely affect the access to finance by the poor. The impact of the earthquake is high in the business of Small Farmer Development Bank (SFDB) and its partner Small Farmer Cooperatives (SFCs) and cooperatives as their business is heavily concentrated in the earthquake affected districts. The government and other donors have proposed program for providing relief and support for constructing the houses of affected families. None of the institution to date has proposed to support affected families for reviving their livelihoods. Therefore, the ADB and Ministry of Finance (MoF) has proposed to implement following activities in partnership with the SFDB:

- (i) Enhancing access to finance to affected clients of SFCs/cooperatives to restore business and livelihood activities
- (ii) Addressing the liquidity crunch faced by partner SFCs/cooperatives of SFDB so that they will be able to allow members to withdraw their savings
- (iii) Providing training to local people for the construction of earthquake resistance houses

3. Cooperative is a voluntary association of group of individuals who come together in order to meet the members' needs through a jointly – owned and democratically control business unit of their choice. Unlike other MFIs, cooperative businesses are confined in one Village Development Committee (VDC) or adjoining VDCs. If catastrophe like recent earthquake occurs; members' life, houses, cattle, crops and other businesses of certain location will be affected. Members in such situation are forced to make request for savings withdrawal submit insurance claims. In addition to this there is high demand of loan to revive business. Cooperatives are not prepared to cope with the catastrophe situation. After 25<sup>th</sup> April earthquake, almost all MFIs and banks resumed basic banking services (cash withdrawals and deposits) but many SFCs and cooperatives in the affected areas could not resume operations mainly because of (I) the buildings are collapsed and they lost members' data and records (II) they lacked sufficient liquidity to return members' deposit or to provide new loans. Banks and MFIs have many branch networks, and even if one or more branches are affected they resume operation from

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<sup>1</sup> These districts are Kathmandu, Lalitpur, Bhaktapur, Dhading, Nuwakot, Rasuwa, Sindhupalchok, Kavrepalanchok, Gorkha, Dolakha, Ramechhap and Sindhuli (highly affected districts); and Makwanpur, Chitwan, Okhaldhunga, Lamjung, Bhojpur and Udayapur (affected districts).

unaffected branches. Their businesses are diversified and impact of quake in the portfolio is not severe. However, businesses of SFCs and cooperatives are concentrated in one location and whole operations are affected. They are in dire need of external support at this time. As of April, 2015, out of total NRs 18 billion portfolios of 432 partner SFCs and cooperatives (of which NRs 7.65 billion is financed by SFDB) about 14% is at risk. If external support is not provided, it will adversely affect the performance of SFDB and cooperative movement as a whole.

4. Total budget proposed for the project is \$7,000,000 of which 79% (\$5,500,000) is allocated for credit funds (lending funds) and 13% (\$900,000) for training to construct earthquake resistance houses. Of the balance funds, 8% (\$600,000) is allocated to operating and overhead cost, and other project interventions.

## 2. Important features of the proposal

5. The few features on the proposal are summarized below.

- (i) **Proposed areas of the project:** SFDB will initiate interventions from three districts: Dhading, Rasuwa and Nuwakot, which are also categorized as most affected districts. These districts are selected as SFDB business is highly concentrated in these areas and it will also help to measure the impact of intervention in the future. About 12,500 most affected households will be provided loan for restoring livelihoods. The intervention in remaining seven districts will be introduced in the second phase based on resource availability.
- (ii) **The loan product:** The loan product aims to revive livelihood/business (purchase livestock, equipment and seeds and restart enterprises), repair animal sheds and houses. The reviving of businesses will help to bring back the economy in right track after the shocks. The loan product is aimed to allow members to use in flexible way to restore their livelihood. The loan limit per client is set NRs50,000 to be paid in three years with 9% interest per annum. The average loan size is estimated NRs40,000 and it will be one time loan product to restore the livelihood of affected members'.
- (iii) **Addressing the liquidity crunch faced by Cooperative/SFCLs:** Demand for withdrawal of savings, insurance claims and credit have increased immensely by the members following the quakes due to increased demand for money to stay safe in the short-run and to recover themselves in the long-run. SFCs and cooperatives lack sufficient liquidity to allow members withdrawing savings and pay the insurance claims. Out of total loan portfolio, 60% (NRs10 billion) is financed by internally generated sources (savings and equity). In the selected districts about NRs824 million is collected as deposits and premium of livestock insurance. Normally a cooperative needs about 10% deposits as a liquid fund; in the crisis situation the SFDB has estimated that a cooperative needs NRs165 million (20 % of NRs824 million) as liquid fund to address liquidity need.
- (iv) **Creation of a risk mitigation fund:** Risk associated in lending in the earthquake affected areas is perceived to be higher than other regions. But no study is conducted in this area to assess the risk of lending to earthquake affected families. Since the credit risk in this area is not evaluated it is important to design an additional cushion to mitigate risks.

- (v) **Training to construct earthquake resistance houses:** In collaboration with Department of Urban Development and Building Construction and Council for Technical Education and Vocational Training (CTEVT) and other technical institutions SFDB will provide training for constructing earthquake resistance houses (masons and carpenters) in the earthquake affected areas. The comprehensive training is designed as on-the-job training where participants construct houses for members. The house models will be as prescribed by the government.

### **3. Risks and long term sustainability**

6. The proposal is mainly designed based on secondary data and limited experience with cooperatives operating earthquake affected people. Project identifies cooperatives as low cost, client driven model more appropriate for responding the crisis.

7. The project implementing institution (SFDB) also lack previous experience of working with earthquake affected people

## **B. Institutional Analysis**

### **1. Institutional Background and Overview**

8. SFDB was established in 2001 to act as a financing institution for Small Farmer Cooperatives (SFCs), scattered throughout Nepal. The Agricultural Development Bank Limited (ADBL) acted as the promoter and main shareholder of the institution. SFDB was licensed as a microfinance bank under the Banks and Financial Institutions Act categorized as D type by the Nepal Rastra Bank (NRB) in June 2005. SFDB serves around 500 SFCs/cooperatives and each year new SFCs are replicated and registered with the Cooperative Department and are included as new clients for SFDB. Most of the SFCLs have demonstrated the capacity to run as financially sustainable institutions serving its members; while others are still at a developing stage. During the year 2009 with the support from the Asian Development Bank, under Rural Finance Cluster Program-II, SFDB has initiated strategy to work with financial cooperatives operating in the hills and mountains of Nepal. Currently SFDB is working with about one hundred financial cooperatives in the hills and mountains of Nepal.

9. SFDB is considered as one of the leading wholesale MFI specialized mainly in cooperative sector. SFDB has a much diversified ownership structure representing SFCL 39%, ADBL 22%, two commercial banks 9% and public 30%.

### **2. External Supervisory Context**

10. SFDB is supervised by the Nepal Rastra Bank as a D type of institution under the Banks and Financial Institutions Act. Six quarterly reports are specified for D type of institutions:

- (i) Capital report,
- (ii) Risk report,
- (iii) Provision report,
- (iv) Overdue loan report,
- (v) Profit and loss statement, and
- (vi) Balance sheet.

11. For the last year, all the reports as stipulated by NRB, have been submitted on the due date according to specified format by SFDB. There are indicators used by NRB to measure performance of D type financial institutions. Following table details the indicators and SFDB's achievements during last

six years. SFDB has complied with all the reporting requirements of NRB and the performance indicators are above the minimum specified limits. Therefore it has achieved 100% compliance.

**Table 1: Financial Indicators of Small Farmers Development Bank**

SFDB Key Performance Indicators (KPIs)												
	NRB Compliance	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	
		2061/62	2062/63	2063/64	2064/65	2065/66	2066/67	2067/68	2068/69	2069/70	2070/71	
<b>A</b>	<b>Basic Data/ Information</b>											
a	Total Equity (Rs. million)		172	185	227	245	339	362	398	488	713	882
b	Total Debt (Rs. million)		751	835	1,131	1,230	647	836	2,155	3,207	3,789	5,223
c	Total Assets (Rs. million)		1,000	1,122	1,485	1,658	1,137	1,310	2,699	3,948	4,894	6,607
d	Earning Assets (Rs. million)		911	1,000	1,356	1,506	1,054	1,256	2,583	3,695	4,629	6,425
e	Liquid Assets (Rs. million)		96	122	128	196	378	215	836	1,281	1,263	1,239
f	Gross Loan & Advances (Rs. million)		864	959	1,327	1,445	752	1,116	1,877	2,676	3,632	5,366
g	Good Loans (Rs. million)		806	856	123	1,291	738	1,055	1,830	2,647	3,609	5,360
h	Core Capital (Rs. million)		172	185	227	245	339	362	183	436	485	637
i	Risk Weighted Assets (Rs. million)		-	1,113	1,500	1,651	933	1,262	2,204	3,117	3,967	5699
j	Book Net Worth per share (Rs.)		154	161	189	199	275	281	309	348	498	383
k	Net Interest Income (Rs. million)		13	22	38	45	21	60	60	80	179	230
l	Interest Expenses (Rs. million)		67	72	82	97	72	61	104	175	196	224
m	Operating Cost (Rs. million)		84	95	118	162	89	93	143	254	248	292
n	Operating Income (Rs. million)		81	94	120	149	101	123	186	318	377	456
o	Operating Profit/Loss (Rs. million)		(3)	(0.9)	1	(12)	12	30	63	43	128	164
p	NPBT (before considering extraordinary items) (Rs. million)		0.7	0.7	1	10	22	27	42	90	124	165
q	Net Profit (after tax) (Rs. million)		0.5	0.5	1	7	15	19	29	63	86	115
r	Staffing (Nos.)		-	-	44	56	49	48	47	48	46	46
v	Inflation Rate		6.2%	8%	6.4%	7.7%	9.2%	10.5%	9.6%	8.3%	9.9%	9.1%
w	Average Market Rate		9.6%	9%	7%	6.8%	7.5%	7.6%	9.4%	9%	6%	4.7%
<b>B</b>	<b>Ratios</b>											
<b>1</b>	<b>Solvency Test</b>											
a	Total Debt to Total Equity Ratio (%)		436.1	450.7	496.9	501.7	190.7	230.6	540.8	656.5	531.2	591.77
b	Total Equity to Total Assets Ratio (%)		17.22	16.52	15.33	14.79	29.85	27.69	14.76	12.37	14.57	13.36
c	Total Debt to Total Assets Ratio (%)		75.11	74.45	76.16	74.21	56.93	63.85	79.83	81.24	77.43	78.35
d	Interest Coverage Ratio (%)		101.0	100.9	101.9	110.7	130.5	144.	140.2	151.8	163.4	173.69
e	Core Capital Ratio (%)	4%	#DIV/	16.65	15.15	14.85	36.37	28.70	8.32	13.99	12.24	11.18
f	Capital Adequacy (%)	8%	#DIV/	17.89	16.47	16.21	37.16	29.59	9.18	14.86	13.16	12.13
<b>2</b>	<b>Profitability / Sustainability</b>											
a	Return on Assets (NP after tax/Average Assets) (%)		0.05	0.04	0.08	0.43	1.33	1.45	1.08	1.61	1.77	1.73
b	Return on Equity (NP after tax/Equity) (%)		0.28	0.25	0.49	2.91	4.47	5.25	7.30	12.98	12.12	12.99

Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities (RRP NEP 49202)

c	Earning per share (EPS) (Rs.)		0.29	0.28	0.63	1.92	12.32	14.78	22.57	45.28	49.97	50.09
d	Price to Earning Ratio (P/E Ratio)		-	-	-	-	-	-	-	-	-	27.23
E	Financial Self Sufficiency (FSS) (%) (Note 3)		80.94	79.12	78.68	65.09	86.33	86.55	62.84	71.35	97.82	106.43
<b>3</b>	<b>Efficiency Test</b>											
<b>3</b>	<b>Operating Efficiency</b>											
<b>a</b>	Net Spread (Interest Earned % - Interest Paid %)		1.26	1.64	2.36	2.44	1.84	3.17	4.03	5.33	5.06	4.42
b	Net Operating Income to Average Assets (%)		(0.35)	(0.08)	0.12	(0.78)	1.06	2.30	2.36	1.09	2.63	2.46
c	Cost to Income Ratio (Operating) (%)		104.3	100.9	98.51	108.6	88.17	75.61	76.89	79.98	65.83	64.07
d	Portfolio Yield (Interest Earned/Average Loan) (%)		9.11	8.80	8.97	9.21	7.74	11.49	10.59	11.53	10.35	9.06
e	Operating Efficiency (Operating Cost/Average Loan) (%)		10.78	10.50	10.39	11.74	8.14	10.00	9.58	11.20	7.88	6.50
<b>3</b>	<b>Staff Efficiency</b>											
<b>b</b>	Operating Income per Staff (Rs. million)		#DIV/	#DIV/	0.04	(0.23)	0.24	0.63	1.36	0.90	2.80	3.57
b	Staff Expense to Operating Income (%)		7.71	8.97	8.00	7.59	10.90	11.12	7.06	6.29	5.84	5.90
c	Staff Cost as % of Total Operating Cost (%)		7.39	8.88	8.12	6.99	12.36	14.71	9.19	7.86	8.88	9.21
d	Good Loan per Staff (Rs. million)		#DIV/	#DIV/	2.81	23.06	15.08	21.99	38.95	55.15	78.46	127.62
<b>4</b>	<b>Portfolio Quality</b>											
a	Performing Loan (%)		94.26	97.84	95.99	94.63	98.15	98.60	97.51	98.93	99.35	99.89
b	NPL (%)	2%	5.74	2.16	4.01	5.37	1.85	1.4	2.49	1.07	0.65	0.11
c	Loan Loss Reserve Ratio (%)		2.85	3.31	3.95	5.28	2.83	2.91	2.41	2.09	1.66	1.13
d	Repayment Rate (%)						99.86	99.21	97.51	98.61	99.47	99.78
<b>5</b>	<b>Liquidity Growth</b>											
a	Liquid Assets to Total Assets (%)		9.69	10.94	8.65	11.83	33.27	16.47	30.98	32.46	25.81	18.59
<b>6</b>	<b>Business/ Revenue Growth</b>											
a	Earning Assets to Total Assets (%)		91.14	89.11	91.38	90.81	92.73	95.89	95.70	93.60	94.59	96.37
b	Total Assets Growth(%)		16.67	12.21	32.32	11.69	(31.43)	15.22	106.02	46.25	23.95	36.23
c	Loan Portfolio Growth (Gross) (%)		22.24	11.07	38.26	8.92	(47.93)	48.28	68.22	42.54	35.74	47.72
d	No. of Clients Growth (%)		#DIV/	<b>20.73</b>	<b>51.47</b>	<b>7.33</b>	<b>4.73</b>	<b>9.46</b>	<b>18.85</b>	<b>21.25</b>	<b>40.46</b>	<b>12.72</b>
e	Women Participation (% of Total Clients)		45.86	48.12	49.46	52.43	53.91	59.13	63.02	65.14	67.38	69.50
<b>Note:</b>												
1	NPBT = Net Profit before Tax											
2	NPL = Non-performing Loan											
<b>Calculation of Financial Self Sufficiency Ratio (FSS)</b>												
FSS = $\frac{\text{Operating Revenue (Loan + Investment)}}{(\text{Operating Cost} + \text{Loan Loss Provisions} + \text{Financing Costs} + \text{Adjusted Cost of Capital})}$												
Where,												
Adjusted Cost of Capital = [ Inflation Rate * (Average Equity - Average Fixed Assets)] + [ (Average Funding Liabilities * Market Rate of Debt) - Actual Financing Costs]												
<b>(Inflation Rate is as per monetary policy of respective years )</b>												

Source: Small Farmers Development Bank.

### 3. Regulatory Compliance

12. SFDB has conducted external annual audit every year by using a duly chartered account as per the Nepal Rastra Bank (NRB)-central bank of Nepal directives. The bank has been following the account keeping as per the requirement of the central bank directed formats to comply with the provision made by Banking and Financial Institution Act (BAFIA) 2006 and Nepal Accounting Standards (NAS). The external annual audit reports were made public by including them in annual reports and publishing and distributing reports to stakeholders. The audit reports so far have not made any significant noncompliance notes.

13. Under BAFIA, NRB regulate and supervise A, B, C and D class financial institutions. SFDB as a D class financial institution, report to NRB about capital adequacy ratio, risk report, provisioning report, overdue loan and financial statement on quarterly basis. NRB conduct off-site monitoring based on these reports. Besides, NRB also conduct on-site in-depth inspection of financial institutions at least once in two years.

14. The bank has classified loans and has made adequate provisioning for loan as per central bank directive<sup>2</sup>. The bank has also maintained core adequacy ratio and non-performing loan as per central bank directive (refer to table-1). Central bank directives are the minimum requirement, not the ceiling. The bank has adopted tighter regime while provisioning for loan loss, level of non-performing loan and maintaining capital adequacy ratio.

### 4. Board and Management

15. The board of directors of the bank comprise of 3 members representing small farmer cooperatives, 2 members from general public, 1 member from ADBL, 1 member from commercial banks and one professional board member. One member representing SFCs is appointed as the chairman of the board of directors. Board members have long years (ranging from 10–25 years) of experience in credit cooperatives, rural development, microfinance activities, development banking and commercial banking sector. A list of board of directors and a brief bio-data is stated in table-2. Lack of female representation at board level and lack of exposure on international best practices in microfinance is identified as a weakness.

16. SFDB's day-to-day operations are managed by the chief executive officer (CEO). Mr. Jalan Kumar Sharma was appointed in October 2009 as CEO through a public advertisement process. All the previous CEOs of SFDB were seconded from ADBL. Mr. Sharma holds a master's degree and has worked in the banking sector for more than 30 years. CEO is assisted by senior managers, program coordinator and managers in the areas of finance, human resource, credit, internal audit and general administration. Additional details of SFDB's senior managers are given in Tables 3.

**Table 2: Brief Bio-data of the Board of Directors of SFDB**

SN	Name	Representing Institution	Designation	Education	Experiences
1	Mr. Khem Bd Pathak	SFCL	Chair person	BA <sup>a</sup>	Board Member in SFDB since May, 2002 Elected as Chairperson in January 2015 31 years experiences in social

<sup>2</sup> The rate stood at 1% initially, up to first three months of defaults, 12% for rescheduled loans, 25 % for the defaults of 3- 6 months, 75 % for the defaults of 6 -12 months and 100% thereafter.

					mobilization, cooperative management and Rural Finance
2	Mr.Sukha Dev Neupane	SFCL	Board Member	IA	Board Member in SFDB since January, 2015 34 years experiences in social mobilization, cooperative management, Rural Finance and Rural Development field
3	Mr.Rabindra Yadav	SFCL	Board Member	BA	Board Member in SFDB since January, 2015 10 years experiences in social mobilization, cooperative management, Rural Finance and Rural Development
4	Mr.Anil Kumar Upadhya	ADBL	Board Member	MBA	Board Member in SFDB since 29 years of experiences in Agriculture and Rural Finance
5	Mr. Khunjan Prasad Mishra	NBL	Board Member	M.Com	Board Member in SFDB since 25 years of experiences in Agriculture and Rural Finance
6	Mr Umesh Lamsal	IPO	Board Member	M.B.S	Board Member in SFDB since 25 10 years of experiences in banking, cooperative and investment sector
7	Mr. Shankar Shrestha	IPO	Board Member	BBS	Board Member in SFDB since 10 years of experiences in banking, cooperative and investment sector
8	Prof.Dr Umakanta Silwal	Director Professional	Board Member	PH.D	Board Member in SFDB Retired professor of Tribhuvan University 30 years of experiences in economic and rural development

ADBL = Agricultural Development Bank Limited, IA= Intermediate of Arts, BA = Bachelor of Arts, BBS = Bachelor of Business Studies, CA = chartered account, MBA = Master's Degree in Business Administration, MBS = Master's Business Studies, MBS = Master's in Commerce, SFCL = Small Farmers Cooperatives Limited, SFDB = Small Farmers Development Bank.

<sup>a</sup> Intermediate of Arts.

Source: Small Farmers Development Bank.

**Table 3: Qualifications of Senior Managers of SFDB**

SN	Name	Designation	Educational qualification	Work Experience
1	Jalan Kumar Sharma	Chief Executive Officer	MBA/Master of Science	Above 30 years' experience in Microfinance and Rural Banking
2	Jhalendra Bhattarai	Senior Manager	B.Com/B. Ed	18 years in Microfinance, institutional development and training
3	Anju Pathak-	Senior Manager- MIS and unit office at Kathmandu <sup>a</sup>	M.A.	12 years in Microfinance and MIS
4	Krishna Prasad Lamichhane	Program Coordinator	M.A	30 years in Microfinance, institutional development and training
5	Shiva Hari Aryal-	Manager- Procurement, General Service and	MBA	9 years experiences in Microfinance, accounts and internal audit

		Compliance		
6	Liladhar Dhital	Manager-Account	MBA	18 years experiences in institutional development, branch management and Microfinance
7	Bhim Prasad Gaire	Manager Internal Auditing	MPA	32 years experiences in institutional development, branch management and Microfinance
8	Kiran Kumar KC	CA	CA	3 years' experience in accounts and internal audit
9	Surya P Hada	Program Coordinator Solar	MBA	30 Years' experience in ADBL
10	Ankur Mainali	IT Engineer	Bachelor	3 years' experience in IT
11	Krishna Aryal	Lead Trainern IFAID	MBS	9 years experiences in institutional development, branch management and Microfinance
12	Deepak K KC	Consultant HR	MA	30 years experiences in institutional development, branch management and Microfinance
13	Ganesh P Bhattarai	AO Manager	MA	5 years in institutional development, branch management and Microfinance
14	Saraj Bhattari	AO Manager	MBS	1 year experiences in branch management, institutional development and Microfinance
15	Raj Kumar Yadav	AO Manager	BA	15 years experiences in institutional development, Cooperative, branch management and Microfinance
16	Krishna Kumari Sharma	AO Manager	MBS	5 years experiences in institutional development, branch management and Microfinance
17	Sher Bahadur Chaudary	AO Manager	MA	10 years experiences in institutional development, branch management and Microfinance
18	Bishnu Khalekhati	AO Manager	l.com	2 years experiences in institutional development, branch management and Microfinance
19	Bishal Kumar Tuladhar	AO Manager	MA	25 years experiences in Cooperative, institutional development, branch management and Microfinance
20	Yuga Raj Gaire	AO Manager	MBA	5 years experiences in institutional development, branch management and Microfinance
21	Keshav Raj Poudya	AO Manager	MBS	1 year experiences in institutional development, branch management and Microfinance

AO = area office, B.A. = Bachelor of Arts, M.A. = Master of Arts, MBA = Master's Degree in Business Administration, MPA = Master of Public Administration, MIS = management information system.

<sup>a</sup> The unit office at Kathmandu also act as an Area Office and provide whole sale credit to MFIs located at neighboring districts.

Source: Small Farmers Development Bank.

## 5. Human Resources Management

17. SFDB has developed a human resource manual taking into consideration the best practice in human resource management. The manual is a comprehensive document which outlines creation of positions, vacancy, recruitment and transfer, salary and other benefits, code of conduct, and incentives such as salary increments. SFDB maintains detailed information of each staff. Human resource management procedures are satisfactory. Lack of proper staff development plan and performance based staff incentives are identified as key weakness in the human resource management.

## 6. Financial Progress and Institutional Performance

18. **Outreach:** SFDB reaches around 381,000 clients in 432 MFIs (mainly small farmer cooperatives). During the last 4 years, SFDB has shown a growth of around 12 % every year.



19. **Outstanding loans:** As of July, 2015, total outstanding loan is NPR 7.65 billion. Total outstanding loan of partner SFCLs and cooperatives is about NPR 18 billion.

20. **Portfolio quality:** Steady progress shown on quality of the outstanding portfolio. SFDB has maintained above 99% recovery rate since July 2009.

21. **Profitability:** SFDB maintains a profitable operation since the year of establishment. Detailed analyses of all the performance indicators are listed on the table-4.

**Table 4: Information of partner cooperatives of SFDB**

NPR '000'

S N	Particulars	Before Implementation of Restructuring II					After Implementation of Restructuring II				
		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
1	Total Number of Coop	114	141	219	220	224	234	251	291	391	429
	a. Small Farmers Coop	114	141	219	219	219	224	236	267	323	355
	b. Other	-	-	-	1	5	10	15	24	68	74
2	<b>Total Number of Members</b>	<b>71,007</b>	<b>85,730</b>	<b>129,851</b>	<b>139,368</b>	<b>145,962</b>	<b>159,767</b>	<b>189,877</b>	<b>230,225</b>	<b>323,384</b>	<b>364,507</b>
	a. Female	32,563	41,256	64,225	73,070	78,690	94,475	119,655	149,967	217,881	253,343
	b. Male	38,444	44,474	65,626	66,298	67,272	65,292	70,222	80,258	105,503	111,164
	% of Female	45.86%	48.12%	49.46%	52.43%	53.91%	59.13%	63.02%	65.14%	67.38%	69.50%
	% Increase in Female Participation	28.35%	26.70%	55.67%	13.77%	7.69%	20.06%	26.65%	25.33%	45.29%	16.28%
% Increase in Members	21.85%	20.73%	51.47%	7.33%	4.73%	9.46%	18.85%	21.25%	40.46%	12.72%	
3	Share Capital	16,680	29,473	58,850	86,796	132,060	260,930	452,964	624,613	1,048,761	1,345,560
	Deposit	80,811	113,523	202,732	244,233	306,052	530,499	827,173	987,167	1,941,496	2,142,610
	Total Internal Resources	297,324	433,033	727,187	909,293	1,281,614	1,902,109	2,992,873	3,949,913	6,527,290	8,265,499
	Increase in Internal Resources	38.17%	45.64%	67.93%	25.04%	40.95%	48.42%	57.34%	31.98%	65.25%	26.63%
4	Loan Outstanding	1,198,899	1,434,539	2,128,971	2,429,170	2,332,859	3,355,144	4,981,624	6,568,689	10,442,201	13,694,211
	Increase in Loan Outstanding	27.32%	19.65%	48.41%	14.10%	-3.96%	43.82%	48.48%	31.86%	58.97%	31.14%
	Interest Receivable	224,809	253,251	383,226	420,871	137,584	137,357	72,976	72,474	61,754	70,102
	Overdue Amount	203,348	224,600	364,886	373,021	188,498	95,540	123,611	142,384	167,044	280,421
	Overdue as a % of Loan Outstanding	16.96%	15.66%	17.14%	15.36%	8.08%	2.85%	2.48%	2.17%	1.60%	2.05%
	<b>Repayment Rate</b>	<b>62.01%</b>	<b>65.99%</b>	<b>63.25%</b>	<b>66.19%</b>	<b>88.71%</b>	<b>91.59%</b>	<b>95.22%</b>	<b>95.44%</b>	<b>97.46%</b>	<b>96.66%</b>

## 7. Management Information System

22. Lack of appropriate management information system (MIS) is identified as the main weakness of SFDB. SFDB has installed computerized MIS, but it not in full operation and data of branches and head office is not consolidated. Currently SFDB maintained records manually and data is analyzed on excel spreadsheets. SFDB is unable to prepare monthly final accounts or provide outstanding loan balance promptly.

## 8. Product Design and Key Characteristics

23. Key features of the lending product for the proposed project are explained in the table below.

**Table 5: SFDB Proposed Lending Products**

<b>Name of loan:</b>	<b>Wholesale loan</b>
Purpose of loan:	Restoring livelihood of earthquake affected small farmers
Loan amount	Per client maximum amount: NPR 50,000
Interest rate:	9% per annum
Loan term:	Maximum allowed: 36 months
Disbursement	Two installment (60% first and 40% second based on progress of disbursement first installment loan)
Repayment schedule:	Grace period- Six months Interest to be paid monthly and principal to be paid quarterly
Rebate	15 percentage of the interest at the end of loan cycle if interest and principle is paid in time
Collateral:	Guarantee paper signed by the board of directors committing to pay outstanding principal and interest in case of SFCs/cooperatives failure to pay.
Client selection criteria for SFCLs/cooperatives:	SFC/cooperative disburse loan to its member meeting following criteria: <ul style="list-style-type: none"><li>• Member with regular savings and good repayment history</li><li>• Low income households</li><li>• Loan must be used to finance working capital, purchase of productive assets and income generating activities</li><li>• Loan limit per borrower will not be more than NPs150,000 (defined by central bank of Nepal as maximum loan limit for microfinance client)</li></ul>

SFC = Small Farmers Cooperatives.

Source: Small Farmers Development Bank.

24. Loan features are designed based on past experience of SFDB and best practice adopted in lending product design. Loan limit based on equity of the cooperative and interest rates to cover cost is important elements. Collateral specified in the product is to obtain personal guarantee by the official are in line with collateral obtained by other wholesale financial institutions in Nepal.

## 9. Internal Control, Risk and Delinquency Management

25. SFDB has a separate division for internal audit and inspection. This division conducts internal audits of all the area offices and sample of its clients (partner SFCLs). Audit findings are reported to an audit committee consisting of two board members and the manager of the internal audit division. Lack of proper annual internal audit plan, not having adequate resources allocated for the internal audit division, and weakness in follow-up process are identified as key constrains. SFDB needs to improve the internal audit function to strengthen control.

26. Risk management strategies of SFDB are divided into three areas. Loan assessment, loan disbursement, and follow up:

- (i) Activities conducted under loan assessment
  - a. Detail institutional assessment based on key performance indicators. Only the institutions achieving key performance indicators are eligible for loan.
  - b. Loan limit is based on capital of the client institution.
- (ii) Activities at the time of loan disbursement
  - a. Obtain guaranty of the partner institutions board members to repay the loan at an event of default (Personal guarantee of the board members).
  - b. Loan disbursements base on performance and cash flow requirement.
- (iii) Activities adopted for follow up the loans
  - a. Regular visit from area office to monitor progress,
  - b. Follow-up on late payments,
  - c. Audits at regular intervals,
  - d. Imposing penalty on late payments, and
  - e. Imposing restrictions of releasing new loans for SFCs with delayed repayments.

27. SFDB adopts reasonable risk control strategies to ensure proper assessment, disbursement, and to collect repayments on time. Internal audit function needs strengthening to ensure appropriate internal control.

## **10. SFDB SWOT Analysis**

28. The result of a SWOT analysis of SFDB is detailed below:

### **a. Strengths of the banks**

- (i) Major ownership with partner clients;
- (ii) Experience of successful microfinance wholesale lending during the last 15 years;
- (iii) Sustainability-achieved operational self sufficiency, equity per shear, and return on assets are in increasing trend, has satisfactory growth rate and comparatively low delinquency rate;
- (iv) Reaching to the rural poor
- (v) Satisfactory systems and procedures; and
- (vi) Experiences and managers
- (vii) Obtained support from other microfinance development projects such as the ADB, UNCDF and IFAD.

### **b. Weakness**

- (i) Inadequate staff performance assessments;
- (ii) Need to improve efficiency of the operation;
- (iii) Lack of diversified client base;
- (iv) Lack of appropriate mechanism to provide technical support for partner institutions to upgrade their capacity.

### **c. Opportunities**

- (i) More opportunities to expand business at regional office level,

- (ii) Larger number of cooperatives operating in Nepal needs wholesale funding,
- (iii) Attract fund from commercial banks deprived sector lending,
- (iv) Government credit to provide loan for enhancing meat production
- (v) Government for capacity development of partner institutions and replication of SFCs
- (vi) Possibilities to obtain support from other microfinance development projects.

**d. Threats**

- (i) The Government managed subsidies credit projects, e.g., self- reliance fund and poverty alleviation fund distort the market;
- (ii) The loan waiver scheme announced by the Government for earthquake victims;
- (iii) Political instability in Nepal;
- (iv) Lack of micro and small business opportunities; and
- (v) Poor infrastructure.

29. SFDB has successfully implemented RFSDCP-II and other projects in the past and it has strengths to implement the proposed project successfully. Already, SFDB is considering strategies to exploit the opportunities identified.

**11. Recommendation on funding**

30. Based on the positive institutional assessment and the desired impact of the project for access to finance to earthquake affected families in Nepal, funding is recommended.

31. Items mentioned below are important preconditions for funding:

- (i) Strengthening of capacity of board
- (ii) Improve internal audit function,
- (iii) Implementation of automated MIS system, and
- (iv) Obtain funding to cover other costs of the project.

32. Reporting requirements for the project:

- (i) Monthly progress report,
- (ii) Annual financial audit report for project funds, and
- (iii) End of project impact assessment.

**12. Conclusion**

33. SFDB is a leading service provider for the financial services in Nepal. It brings a range of strength to address the needs of earthquake affected families in the rural villages. It has very good track records of expanding services in the hills, mountains and rural villages. It needs to be improved in MIS and internal audit functions. The proposed interventions will help both partner SFCs/Cooperatives and SFDB to successfully revive their business and will help to restore the livelihood activities of members.